June 16, 2022

VIA INTERNET

Dear Interested Party:

The Audit Manual (AM) is a guide for the California Department of Tax and Fee Administration (CDTFA) in administering tax and fee programs. It is available to the public and can be accessed from the CDTFA web page at https://cdtfa.ca.gov/taxes-and-fees/staxmanuals.htm.

The Business Tax and Fee Division is proposing to revise AM Chapter 5 to update the entire chapter. Because the chapter is so large, it has been separated into three sections. This section, 0504.00 to 0508.00 and 0512.00 covers failure to pay, negligence in keeping records, negligence in preparing returns and miscellaneous items.

The revision material is provided on the following pages for the convenience of interested parties who may wish to submit comments or suggestions. Please feel free to publish this information on your website or otherwise distribute it to your association/members.

If you have any comments or suggestions related to the proposed AM revisions, you may contact the CDTFA at BTFD-BTCT-AM.RevisionSuggestions@cdtfa.ca.gov. Your comments or suggestions must be received by the CDTFA no later than July 18, 2022 in order to be considered. Thank you for your consideration.

Sincerely,

Aimee Olhiser
Tax Policy Bureau Chief
Business Tax and Fee Division
FAILURE TO PAY

WHEN PENALTY ATTACHES

RTC section 6591 and similar special tax and fee sections impose a 10-percent penalty for failure to pay tax timely if tax is not paid, as follows:

- To-Fo self-declared tax, when not paid on or before the due date of the return or before the expiration of any extension that has been granted.
- To-Fo determinations made by the CDTFA, when not paid on or before the penalty finality date shown on the Notice of Determination unless a timely petition has been filed.
- To-Fo redeterminations, when not paid on or before the penalty finality date shown on the Notice of Redetermination.

PETITIONS FOR REDETERMINATION

RTC section 6565 and similar special tax and fee sections impose a 10-percent penalty for failure to pay the amount of any determination made by the CDTFA which is not paid on or before the date the determination becomes final (the “finality date”). (30 days after service of notice of determination), unless a petition for redetermination is filed on or before that date. Generally, a notice of determination becomes final 30 days after the date the notice was mailed or personally served unless a petition for redetermination is filed on or before the finality date. (See AM 0504.20 for Jeopardy Determinations.) The rules for determining when a petition was filed are the same as those for determining when a payment was made.

A petition for redetermination is considered timely if it is filed on or before the finality date. Generally, a petition filed through CDTFA’s online system is automatically accepted by the system as a timely petition, when it is filed prior to the finality date. Petition requests received outside CDTFA’s online system (via mail, email, fax) are evaluated by Petitions Sections (Petitions)/Appeals and Data Analysis Branch (ADAB) team members to determine timeliness (team members will review postmark date, emailed date, etc.). Once a petition is acknowledged as timely and valid, an “Active Appeal Case” indicator is placed on the Customer springboard in the system, which prevents collection action and the 10-percent penalty from being assessed.

If a timely petition is not filed and tax is not paid on or before the finality date, the 10-percent penalty is automatically assessed. In preparing a reaudit, the auditor should determine if the petition was timely. The taxpayer should be notified of any penalty to be added by Headquarters because of a late protest or late payment. Comments on the audit report Verification Comments in the system should also indicate that a penalty will be added by Headquarters, or was, assessed. Additionally, the system sends a Demand Notice and Statement of Account, notifying the taxpayer of the outstanding balance due, including a detail of any new penalties assessed.

PAYMENTS OR PETITIONS MAILED BUT NOT RECEIVED

For purposes of determining whether a late payment or late filing penalty is applicable, or a petition is filed timely, a payment or a petition alleged to have been placed in the mail will generally not be treated as received or filed timely unless it is actually received by the CDTFA received by CDTFA. Exceptions will be made in those instances where the taxpayer furnishes satisfactory proof that the original payment or petition was mailed timely.
JEOPARDY DETERMINATIONS

0504.20

Jeopardy determinations are immediately due and payable and become final within 10 days after service of the notice of jeopardy determination was mailed or personally served, unless a petition for redetermination is filed within such period and security is deposited within such period, in such amount as the CDTFA may deem necessary. The CDTFA will not recognize a petition in connection with a jeopardy determination unless such security is deposited with the CDTFA in one or more of the following forms:

- Cash deposits, including cashier check and money order (personal checks not acceptable).
- Certificates of deposit issued by banks.
- Savings and loan certificates.

A document that purports to be a petition for redetermination filed in connection with a jeopardy determination where security is not deposited is not a valid petition. If the amount specified is not paid within 10 days after service of notice, the service date of the notice of jeopardy determination, and without a valid and timely petition, a 10 percent penalty for failure to pay is imposed pursuant to RTC section 6591 and similar special tax and fee sections. A person against whom a jeopardy determination is made may nonetheless apply for an administrative hearing, as provided by RTC section 6538.5, Appeals Regulation 35028.

- Date of mailing of the Notice of Determination or the date the Notice of Determination was delivered in person to the taxpayer.

PREPAYMENTS

0504.25

RTC section 6476 and section 7659.5 imposes a 6-percent penalty and sections 43155 and 12258 provide a 10-percent penalty on the amount of a prepayment that is paid late, but which is paid before the last day of the monthly period following the quarterly period in which the prepayment was due.

RTC section 6477 imposes a penalty when a taxpayer fails to make a prepayment before the last day of the monthly period following the quarterly period in which the prepayment became due, but files a timely return and payment for the quarterly period in which the prepayment became due. The penalty is 6 percent of the amount equal to 90 percent of the tax liability for each of the periods during that quarterly period for which a required prepayment was not made.

The 6-percent prepayment penalty imposed under RTC sections 6477 and 7659.6 is increased to 10 percent if the failure to make the prepayment was due to negligence or intentional disregard imposed under RTC section 6477 is increased by RTC section 6478 to 10 percent if the failure to make the prepayment was due to negligence or intentional disregard of the Sales and Use Tax Law or authorized rules and regulations. RTC section 6478 also imposes a 10 percent penalty on the amount of any deficiency in the required prepayment if any part of that deficiency is the result of negligence or intentional disregard of the Sales and Use Tax Law or authorized rules and regulations. The penalties discussed in this paragraph are not applicable to amounts subject to a penalty under RTC sections 6484, 6485, 6511, 6514, or 6591.

Prepayment penalties are not assessed in sales and use tax audits. For examples on the application of prepayment penalties, including situations in which multiple penalties can or cannot be assessed, see examples in the tables provided in sections 0501.22 and 0501.23.
The penalties imposed in RTC sections 6479.3 and 6591, and similar special tax and fee sections, apply to taxpayers who are required to pay taxes by means of Electronic Fund Transfer (EFT) and fail to do so. These penalties are limited to a maximum of 10 percent of the amount of taxes, exclusive of prepayments, for the reporting period. Failure to pay prepayments by electronic funds transfer is subject to a penalty of 6 percent of the prepayment amount incorrectly remitted (RTC section 6479.3 (e)(2)).

For examples for the application of electronic fund transfer related penalties, including situations in which multiple penalties can or cannot be assessed, see examples in the tables provided under sections 0501.22 and 0501.23.
AMNESTY PENALTIES 0505.00

Beginning April 1, 2005, amnesty penalties may be applied to sales and use tax liabilities for reporting periods that began prior to January 1, 2003. See AM section 0206.520 0206.41 for audit comments regarding the Amnesty Program.

50 PERCENT INTEREST PENALTY 0505.05

A. Application

The penalty is imposed pursuant to RTC section 7074 and applies to taxpayers who meet any of the following criteria:

- Qualified for amnesty but did not participate.
- Participated in amnesty but underreported their tax liabilities.
- Applied for amnesty but did not enter into an Installment Payment Agreement (IPA) or pay their tax liability by May 31, 2005.

The penalty does not apply to:

- Tax liabilities for eligible tax reporting periods that were included in an IPA in place January 31, 2005.
- Tax liabilities included in an amnesty IPA, even if the taxpayer subsequently defaults on its agreement.
- Tax liabilities for reporting periods not eligible for amnesty, for example, reporting periods for which a criminal court proceeding had been initiated against the taxpayer prior to amnesty.
- Eligible tax reporting periods where the tax portion of the liability was paid in full on or prior to March 31, 2005 (non-participant) or May 31, 2005 (participant).

B. Computation

The penalty is equal to 50 percent of the interest on the unpaid tax amount remaining due as of March 31, 2005 (non-participants), or May 31, 2005 (participants who did not fulfill all program requirements), computed from the day following the original due date of the tax through March 31, 2005.

The penalty applies to both self-assessed and CDTFA-assessed sale and use tax liabilities and is imposed beginning April 1, 2005 (non-participants) or June 1, 2005 (participants who did not fulfill all program requirements). With regard to CDTFA-assessed liabilities, the penalty is imposed at the time the liability becomes final. Payment of the deficiency prior to the finality date does not prevent the penalty from applying.

DOUBLE PENALTIES 0505.10

In addition to the 50-percent interest penalty, underreporters and nonreporters are subject to a penalty that doubles the rate of all penalties (except the 50 percent interest penalty) applicable to a Notice of Determination issued on or after April 1, 2005 (RTC section 7073). Additionally, if the finality penalty is imposed, it will be applied at double the normal rate.
NEGLIGENCE PENALTIES — GENERAL 0506.00
LEGAL BASIS 0506.05
The RTC sections relating to the negligence penalty contain language like the following: the following language:

“If any part of the deficiency for which a deficiency determination is made, is due to negligence or intentional disregard of this part or authorized rules and regulations adopted under this part, a penalty of 10 percent of the amount of the determination shall be added thereto.”

DEFINITION 0506.10
Negligence may be defined in general as a failure to exercise due care. In most cases, the law has defined the exercise of due care as such care that a reasonable and prudent person would exercise under similar circumstances. With respect to business tax matters, negligence may be further defined as a substantial breach by the taxpayer of some duty imposed by the law or authorized rules and regulations.

NEGLIGENCE VS. INTENTIONAL DISREGARD 0506.15
There is a technical distinction between negligence and intentional disregard of the law or authorized rules and regulations in that intentional disregard implies something more than negligence. However, intentional disregard is less than fraud or intent to evade the tax and is covered by the “negligence penalty.” Accordingly, the term “negligence penalty” will be used to include the penalty for negligence or for intentional disregard. If, however, a situation is encountered where the field auditor believes there is strong evidence of intentional disregard of the law or authorized rules and regulations, the audit report should include appropriate comments regarding the evidence of intentional disregard.

Field auditors should not assume that a large audit deficiency or overpayment is indicative of either negligence or intentional disregard. The auditor must use his or her highest skill and best judgment to determine whether the amount of tax has been reported correctly. This same skill and judgment should be used to determine whether a penalty should or should not be recommended. Refer to AM section 0101.20, Tax Audit Policies. The auditor must support a negligence penalty with appropriate comments (refer to AM section 0206.450206.35).

ACTS OF AN AGENT, EMPLOYEE OR PARTNER 0506.20
In general, where an agent, employee, or partner of the taxpayer is guilty of negligence, with a resulting tax deficiency, the 10 percent penalty will apply. This is true even though the agent, employee, or partner acted without the taxpayer’s knowledge or consent, or acted contrary to the express instructions of the taxpayer. Situations may be encountered where the taxpayer has been defrauded by an agent, employee, or partner and, as a result, did not benefit from the understatement of tax. Whether the negligence penalty is imposed will depend upon whether circumstances made it difficult or impossible for the taxpayer to detect such fraud. The application of a negligence penalty in these instances should be decided on a case-by-case basis.

CONDITIONS UNDER WHICH PENALTY APPLIES 0506.25
The negligence penalty applies only to deficiency determinations and it applies to the total amount of the tax liability. Generally, this means that, if the penalty applies, it will be apply for the entire period of the audit regardless of the class of transactions involved. Before the penalty is imposed, the following conditions must be present:

• A tax deficiency, and
• Evidence that any part of the tax deficiency is the result of negligence or intentional disregard of the law or authorized rules and regulations.

**PENALTIES APPLICABLE TO ONLY PART OF THE AUDIT PERIOD**

0506.30

Situations may be encountered where the condition warranting the imposition of a negligence penalty is not present during the entire period under audit and where the imposition of the penalty to the entire amount of the tax liability would be inequitable. For example, a complete change of management occurred and conditions under one management were entirely different from those under the other. In this type of situation, the auditor will select the appropriate penalty for the appropriate period(s) only. The system allows auditors to select some periods of an audit for penalty application, prepare two sets of Form CDTFA–414–A or Form CDTFA–414–B, one includes the 10 percent penalty, and the other without the penalty. Audit Determination and Refund Section will issue the Notice of Determination accordingly. The audit report The Verification Comments in the system with the penalty must include a full statement of the facts involved.

When considering the recommendation to impose a negligence penalty on a partial audit period, auditors should determine if the taxpayer made any effort during a subsequent period in the audit to correct the situation which led to negligence. If such an effort has been was made, a penalty may not be appropriate.

**PENALTY COMMENTS ON AUDIT REPORTS OR FIELD BILLING ORDERS**

0506.35

A comment should be made on any area which will be of value in connection with making a determination or with making decisions regarding future audits (see AM section 0206.03 0206.01). Penalty recommendations are frequently a source of disagreement between staff team members and taxpayers. To ensure that both staff team members and taxpayers understand why a negligence penalty was or was not recommended, a penalty comment using the following guidelines must be made in the “General Audit Comments” section of Form CDTFA–414–A or Form CDTFA–414–B Verification Comments on the Audit springboard in the system. The sole exception is when the tax liability is less than $2,500 and no penalty is recommended.

The factors which constitute negligence in keeping records (AM section 0507.00), negligence in preparing returns (AM section 0508.00), and evasion penalties (AM section 0509.00), must be carefully considered before determining whether a negligence or evasion penalty should be imposed. If a negligence penalty is being recommended, the auditor must provide in clear and concise terms the rationale for imposing a penalty. An explanation of the evidence and facts upon which the auditor relies to support the recommendation for imposition of a penalty must be given. The explanation must enable supervisors, reviewers, the taxpayer and/or taxpayer’s representative to determine whether the recommendation is consistent with the facts established by the audit. The comments must be factual, not merely the auditor’s opinion, and must not be stated in a manner derogatory to the taxpayer or the taxpayer’s employees. All penalty comments must be sufficiently clear to provide information that may be useful in subsequent audits of the taxpayer.

If the auditor believes auditors believe the imposition of a penalty is inappropriate, he or she they must use the same penalty comment guidelines as when recommending a negligence penalty. That is, the comments must be clear and concise to enable supervisors and other readers of the audit working papers to determine whether the recommendation is consistent with the facts established in the audit, and to provide information that may be useful in a subsequent audit. “Canned comments” such as “Negligence not noted;” “No negligence noted;” or “No penalty recommended,” do not provide enough information and are not acceptable. See AM 0206.00 for examples.
If an evasion (fraud) penalty is being recommended, the Verification Comments in the system must include the comment, comment on the audit report include “Penalty pursuant to RTC section 6485 [or applicable special tax or fee section] is recommended.” In addition, a memorandum and an Audit Evasion (fraud) Memo case are required from the Administrator to the Deputy Director, Field Operations Division (FOD), or Deputy Director, Business Tax and Fee Division (BTFD), as appropriate, is required from the Administrator to the Chief, Headquarters Operations Bureau (see AM section 0509.75 0509.40 for contents of this memorandum).

To promote consistency in the application of penalties and the writing of penalty comments, all comments must be reviewed by the auditor’s supervisor. In addition, special procedures will be used for the following reviews:

- Audit tax deficiency over $25,000 — Reviewed and approved by the auditor’s supervisor.
- Audit tax deficiency over $50,000 — Reviewed and approved by the Office Making Audit (OMA), Supervising Tax Auditor III or Business Tax Administrator III, after the review and approval by the auditor’s supervisor. Principal Auditor subsequent to the review and approval by the auditor’s supervisor.

A Supervising Tax Auditor III or Business Tax Administrator III will be deemed to have reviewed and approved the penalty comments when they indicate their approval of the audit as a whole, by staging the audit to Audit Review in the system. Supervisors and Principal Auditors will be deemed to have reviewed and approved penalty comments when they indicate their approval of the audit as a whole on the digital audit email approval chain (See AM section 0213.06).

**NEGLIGENCE PENALTIES IN A TAXPAYER'S FIRST AUDIT**

Field auditors Auditors are frequently faced with the decision of whether to recommend a penalty on the first audit of a taxpayer. This decision must be based on an objective evaluation of the audit findings and the taxpayer’s background and experience. Generally, a penalty should not be recommended on a taxpayer’s first audit. However, there are circumstances where a penalty would be appropriate. (See Regulation 1703(c)(3)(A).) If a negligence penalty is recommended on the first audit, the Verification Comment in the system comment “Taxpayer’s first audit” should be made in conjunction with a detailed explanation for the penalty recommendation. Criteria that should be considered, among others, are the taxpayer’s prior business experience, the nature and state of the records provided, and whether the taxpayer used an outside accountant or bookkeeper to compile and maintain the records, and/or to prepare the sales and use tax returns or reports.

Circumstances in which a negligence penalty may be appropriate in a first-time audit include, but are not limited to, the following:

- The business is controlled by a person or persons that control (or controlled) a substantially similar business that was previously subject to audit. In that earlier audit, staff team members documented audit issues which resulted in the understatement of taxable sales. These same issues are present in the current audit and resulted in a substantial understatement of taxable sales. (For purposes of this and the following circumstances, “controlled” or “control” means any person having control or supervision of, or who is charged with the responsibility for, the filing of returns or the payment of tax or who has a duty to act for the entity in complying with any provision of the applicable Revenue and Taxation Code section Sales and Use Tax Law.); or
The business received written advice from the CDTFA regarding a record keeping or reporting issue. In the current audit, the advice received was clearly disregarded, leading to a substantial understatement of taxable sales/transactions. That advice was clearly disregarded, leading to a substantial understatement of taxable sales. (For purposes of this and the following circumstance, “written advice” does not include publications provided to a taxpayer upon registration for a seller’s permit or certificate of registration — use tax permit or account); or

The business is controlled by a person or persons that control (or controlled) a similar business which received written advice from the CDTFA regarding a record keeping or reporting issue. In the current audit that advice was clearly disregarded, leading to a substantial understatement of taxable sales; or

The owner of the business has a history of opening and closing businesses. The owner opens a business, runs it for a year or two, closes it, and then opens a similar business. The owner subsequently closes the new business before any audit is performed, and then opens another, similar business, with the pattern continuing over many years. No audit was ever performed on any of the prior businesses, in part because the businesses closed before an audit was assigned and would normally have been performed. The current audit reveals substantial underreporting which appears to be intentional, but the evidence is not sufficient to meet the clear and convincing evidence standard required to impose a fraud penalty; or

The business has no records of any kind or extremely poor records, which resulted in substantial underreporting. The evidence indicates that it is more likely than not that the lack of records is intentional and is intended to conceal the underreporting; however, the evidence is not sufficient to meet the clear and convincing evidence standard required to impose a fraud penalty; or

The business is controlled by a CPA or former CPA who has prior experience advising businesses of the same type on compliance with the Sales and Use Tax Laws. The audit results in a substantial liability despite the controlling person’s extensive experience advising clients of the same type of business on record keeping and in preparing tax and fee returns and reports. For examples of comments with no negligence penalty applied on a taxpayer’s first audit, see AM Section 0206.35.

The following examples illustrate when a negligence penalty may apply in a taxpayer’s first audit.
Example 1:

Shep Bartlett owned and operated a restaurant serving breakfast, lunch, and dinner, as well as beer and wine. During an audit of the restaurant, Mr. Bartlett provided CDTFA staff team members with monthly sales summaries but had not maintained any source documentation, like such as, purchase invoices, sales receipts, or cash register z-tapes. CDTFA staff team members determined that taxable sales were understated. In the audit working papers, it was documented that Mr. Bartlett had been advised that he was required to maintain source documents and provide them upon audit. Subsequently, Mr. Bartlett formed a corporation, Bartlett, Inc., with himself as the president and sole shareholder. Bartlett, Inc. opened another restaurant which was managed by Mr. Bartlett managed. During the first audit of Bartlett Inc., CDTFA staff team members found that it did not maintain any source documentation such as purchase invoices, sales receipts, or cash register z-tapes, as Mr. Bartlett was previously informed and, upon the current examination of the records, and, upon examination, calculated a substantial understatement of taxable sales. Because the same audit issue was documented in the earlier audit of Mr. Bartlett’s other restaurant, and documentation showed that CDTFA staff team members had advised Mr. Bartlett regarding proper record keeping, and because Mr. Bartlett managed the operation of both restaurants, CDTFA staff team members recommended that a 10 percent negligence penalty be added to the audit determination.

Example 2:

Tony Leo owned and operated a retail store selling antiques to customers both within and outside of California. Mr. Leo wrote to the CDTFA requesting advice regarding what documentation was necessary to support sales in interstate commerce. CDTFA staff team members provided him a written response stating that the sales where the property was to be delivered (to the customer in California) were subject to sales tax. While Sales where documentation showed that the property, pursuant to the contract of sale, was required to be shipped and was shipped, to a location outside California by common carrier, were not subject to tax. During the first audit of the antique store, CDTFA staff team members discovered that Mr. Leo was claiming as exempt sales in interstate commerce, sales whereby the property was delivered to the customer in California. Because Mr. Leo had previously received written advice addressed to him, on this issue and was reporting sales contrary to the specific written advice, CDTFA staff team members recommended that the 10 percent negligence penalty be added to the audit determination.

Note: The recommendation to impose a 10 percent negligence penalty would also apply in the first audit of a business which is controlled by a person or persons that control (or controlled) a similar business which received written advice from the CDTFA regarding record keeping or reporting.

Example 3:

Ace’s Automobiles is a seller of used vehicles. It was opened and originally operated under a seller’s permit taken out by Charlotte Dealer. After two years, the business was closed and Ms. Dealer opened King’s Automobiles, also selling used vehicles. Ms. Dealer closed King’s Automobiles after two years and opened Jack’s Automobiles, again selling used vehicles. Ms. Dealer managed all three businesses. Based on an audit lead, staff team members commenced an audit of Jack’s Automobiles, after it had been in business only two years. This was the first audit of any of Ms. Dealer’s businesses. Audit staff team members found that many of the Reports of Sale were missing and the records they did obtain appeared to have been prepared just for the audit and indicated unrealistically low selling prices based on the make and model of the vehicles sold. As a result, staff team members estimated that taxable sales were substantially understated.
Although this was Ms. Dealer’s first audit, because Ms. Dealer had been operating used vehicle lots for many years, and her past business practices indicated a conscious effort to avoid being audited, staff team members recommended that a 10-percent negligence penalty be added to the audit determination.

Example 4:

Kurt Vaughn owned and operated a company in the business of selling musical instruments. Mr. Vaughn did not report any taxable sales, claiming that all property was shipped out of state, via common carrier, pursuant to the sales contracts. During the first audit of the business, Mr. Vaughn provided annual sales summaries but did not maintain purchase invoices, sales contracts or receipts, shipping invoices, bills of lading, or any other source documentation. Furthermore, records obtained from the common carriers indicated that very few sales were shipped out of state, while a substantial number of shipments were to locations in California. The audit resulted in substantially underreported taxable sales but CDTFA staff team members concluded that there was insufficient evidence to impose a penalty for fraud. However, given the significant understatement of taxable sales, the records from common carriers, and the complete lack of source documentation, staff team members recommended that a 10 percent negligence penalty be added to the audit determination.

Example 5:

Mr. Smith is a Certified Public Accountant (CPA) whose practice, for the last three years, has involved advising and assisting business owners, including numerous restaurants, regarding best practices in running their businesses, and record keeping, and assisting them in preparing sales and use tax returns. Mr. Smith decided to close his CPA practice and open a sushi restaurant, something he always dreamed of doing. In the first audit of Mr. Smith’s restaurant, staff team members found that Mr. Smith had failed to keep complete purchase invoices, had no guest checks or z-tapes, and did not keep records showing any cold food sold “to go.” However, Mr. Smith reported 30 percent of his sales as exempt sales of cold food “to go.” The audit resulted in a substantial liability involving both unreported total sales and unsupported claimed exempt sales of cold food “to go.” Although this was Mr. Smith’s first audit, staff audit team members included the 10-percent included a 10 percent negligence penalty because of Mr. Smith’s extensive experience with the record keeping and reporting requirements for restaurants.

CLASSES OF NEGLIGENCE 0506.45

A taxpayer may be negligent in a number of ways, but there are only two kinds of negligence which will result in a tax or fee deficiency and which may warrant the imposition of the negligence penalty. These are:

- Negligence in keeping records (AM sections 0507.00 — 0507.50), and
- Negligence in preparing returns (AM sections 0508.00 — 0508.50).
Guidelines for the maintenance of records are provided by Regulations 1698, Records, and similar special tax and fee regulations. In general, these regulations provide that taxpayers must maintain and make available for examination, on request by CDTFA, or its authorized representative, all records necessary to determine the correct tax liability under the laws administered by CDTFA. Such records include, but are not limited to: In general, this regulation provides that “a taxpayer shall maintain and make available for examination on request by the CDTFA or its authorized representative, all records necessary to determine the correct tax liability under the Sales and Use Tax Law and records necessary for the proper completion of the sales and use tax return.” Such records include:

- Normal books of account ordinarily maintained by the average prudent business person engaged in the activity in question.
- Bills, receipts, invoices, cash register tapes, or other documents of original entry supporting the entries in the books of account.
- Schedules or working papers used in connection with the preparation of tax returns.

Complete absence of records will constitute strong evidence of negligence. However, auditors should determine if there are mitigating circumstances for the lack of records (see AM section 0507.50). Where records are maintained and a tax deficiency results, various factors must be taken into consideration in determining whether the tax deficiency was due to negligence in keeping records. The term “records” as used herein includes not only those specifically mentioned in Regulations 1698 and 4901, but also such supporting data as resale certificates, shipping documents in support of interstate or foreign commerce transactions, etc. Regulation 1698, but also such supporting data as resale certificates, shipping documents in support of interstate transactions, etc.

**TEST FOR NEGLIGENCE IN KEEPING RECORDS**

The primary test for negligence is whether a taxpayer keeps the type of records ordinarily maintained by a reasonable and prudent businessperson with a business of similar kind and size. If the evidence indicates that a taxpayer failed to keep such records and, as a result, failed to compile tax or fee returns or reports returns with a reasonable degree of accuracy, and cannot substantiate the reported amounts when audited, negligence is indicated, and the 10-percent 10-percent penalty may be appropriate.

**RECORDS NEED ONLY BE ADEQUATE FOR TAX PURPOSES**

Records need only be adequate for sales and use or special tax and fee purposes. The fact that the records may not be adequate for the purpose of preparing balance sheets or profit and loss statements, or for furnishing accurate cost data, information to stockholders, creditors, or others interested in the business does not necessarily constitute negligence for sales and use or special tax and fee tax-purposes.

**RECORDS NEED ONLY BE ADEQUATE FOR TYPE OF BUSINESS**

Records need only be adequate to meet the tax or fee requirements of the type of business involved. For example, a small restaurant may require a very simple set of records for sales and use tax purposes, whereas, a large department store, oil company, automobile dealer, or contractor, will require a much more complex accounting system.
NEGLIGENCE OF OTHER TAXPAYERS — NO EXCUSE 0507.25

A taxpayer should not be relieved of penalty for negligence in keeping records merely because there are many other taxpayers engaged in the same kind of business who are also negligent in keeping records. Each individual case should be decided on its own merits.

EFFECT OF LACK OF KNOWLEDGE ON PART OF TAXPAYER 0507.30

A taxpayer should not be relieved of a penalty for negligence in keeping records merely because the taxpayer is unaware of the requirements of the law. However, while a lack of knowledge is no defense to the negligence penalty, a taxpayer of little education should not be expected to keep records in as good a form as a taxpayer who has wide knowledge of correct accounting principles. The taxpayer cannot be regarded as negligent merely because the records are kept in a foreign language.

ERRORS IN KEEPING RECORDS 0507.35

Where records are adequate for tax or fee purposes, sales and use tax purposes, but with numerous errors that result in the understatement of tax or fee, understate ment of tax, the test for negligence is whether or not the taxpayer exercised due care in keeping the records.

ERRORS DO NOT NECESSARILY CONSTITUTE NEGLIGENCE 0507.40

No matter how carefully records are prepared and checked, some errors may occur. Accordingly, where errors are made in keeping records, the relative frequency and importance of such errors must be considered before a taxpayer is regarded as negligent. Due consideration should be given to any particular accounting difficulties which are inherent in the taxpayer’s business.

CONSIDERATIONS IN CLASSIFYING ERRORS 0507.45

To determine whether errors constitute negligence, the following should be considered:

- **The frequency of the errors relative to the volume of transactions.** The number of errors found must be considered in relation to the total number and dollar amount of the same type of transaction in the audit period.

- **The ratio of understatement to reported amounts.** This percentage of error may be used in a variety of ways. For mark-up audits, the most appropriate evaluation is the ratio of understatement to reported taxable measure, particularly when reported taxable sales have been impeached. For audits where taxable measure is based on a percentage of total sales or claimed deductions, the most appropriate evaluation is the measure of understatement to total reported sales or claimed deductions. For both methods, a large ratio of understatement may be indicative of negligence. If the audit measure is derived from a statistical sample, comparison of the error percentage in the prior audit may be appropriate if the same items are being sampled. A substantive increase or comparable error percentage may be indicative of negligence. However, it must be noted that a ratio of understatement is not, in and of itself, proof of negligence. A ratio should be considered in conjunction with other factors to determine whether negligence has occurred.

- **The cause of errors found by audit.** The cause of errors may result from procedural or operational problems unrelated to negligence. For example, significant changes in sales volume from a prior audit may cause errors that result from staffing problems rather than negligence. Similarly, a business with a large volume of small dollar transactions may find it infeasible to hire the level of staff that would result in the total elimination of errors.
If the errors are too frequent in relation to the volume of transactions, or if the errors result in a higher ratio of understatement than would be expected of a reasonable and prudent businessperson engaged in a business of similar kind and size, or if there appears to have been an absence of due care, the 10 percent negligence penalty should apply.

**DESTRUCTION OF RECORDS** 0507.50

All records pertaining to transactions involving sales or use tax liability must be preserved for a period of not less than four years, unless the CDTFA authorizes, in writing, their destruction within a lesser period.

Whether unauthorized destruction of records constitutes negligence depends on the circumstances in each case.

**Records Accidentally Destroyed**

When the taxpayer has exercised due care in preserving the records, and the records were accidentally destroyed in spite of such care, the taxpayer cannot be said to have been negligent in failing to retain records. In reaching such a conclusion, the auditors should be satisfied that the records were actually destroyed and that the destruction was accidental.

**Records Intentionally Destroyed**

Where records have been intentionally destroyed or destroyed as a result of negligence or lack of due care on the part of the taxpayer, any tax or fee deficiency that is established will be presumed to have been the result of the taxpayer’s negligence in destroying the records. The 10 percent negligence penalty will apply unless there is evidence that the deficiency is not the result of the destruction of the records. Please note that intentional destruction of records may be an indication of fraud or intent to evade the payment of tax or fee (AM sections 0509.00 — 0509.45).
NEGLIGENCE IN PREPARING RETURNS 0508.00
DEFICIENCY DUE TO MISUNDERSTANDING 0508.05

Where there is evidence that the tax or fee deficiency resulted from a reasonable misunderstanding by the taxpayer concerning the application of the tax or fee, no penalty will apply. However, where the taxpayer has been advised, as a result of a prior audit or by other means such as a specific letter, documented telephone call, or special industry notice, that the unreported items were subject to the tax or fee, it can be, it is indicative of intentional disregard and a penalty may apply. The 10 percent 10-percent negligence penalty should not apply when there are mitigating circumstances, such as an attempt on the part of the taxpayer to report the items, or changes in the taxpayer’s type of business or business operations that affected reporting of the transactions in question.

TEST FOR NEGLIGENCE IN PREPARING RETURNS 0508.10

As in the case of negligence in keeping records, the test for negligence in preparing returns is whether the taxpayer failed to exercise the degree of care exercised by an ordinary, prudent businessperson who is engaged in a business of a similar kind and size, and who, in good faith, has attempted to prepare the returns with a reasonable degree of accuracy.

MECHANICAL ERRORS 0508.15

Mechanical errors in compiling returns do not constitute negligence unless such errors are sufficiently frequent or sufficiently large in amount to meet the test for negligence.

ERRORS IN APPLICATION OF LAW 0508.20

Erroneous application of the Sales and Use Tax Law when completing returns does not constitute negligence unless there is evidence that the taxpayer failed to exercise due care in determining whether the transactions in question are subject to tax or fee. The taxpayer may be regarded as having exercised due care if the taxpayer has acted in good faith and has made a reasonably diligent effort to determine how the tax applies to the taxpayer’s business. The average taxpayer can only be expected to exercise the amount of diligence due from an ordinary, prudent businessperson.

DUTY TO MAKE INQUIRY 0508.25

Where there is doubt concerning the correct application of the tax or fee, the taxpayer has a duty to make an inquiry. If the taxpayer fails to make an inquiry, the 10 percent 10-percent negligence penalty may apply. In general, if the taxpayer does make an inquiry and fails to act upon the results of the inquiry, the 10 percent 10-percent negligence penalty should apply.

EFFECT OF ERRONEOUS INFORMATION 0508.30

A taxpayer who was misinformed about the proper application of taxfals to make a timely return or payment resulting from the taxpayer’s reasonable reliance on written advice from CDTFA, may be relieved from the payment of tax or fee, may be relieved from the payment of tax, interest, and penalty if the taxpayer meets the requirements for relief under RTC section 6596 and similar special tax and fee sections (AM sections 0105.00 — 0105.10). If the taxpayer does not qualify for RTC section 6596 relief, the A negligence penalty should not be warranted if the taxpayer provides evidence that they contacted CDTFA to inquire about the proper application/reporting of tax and fee and was misinformed by CDTFA team members, negligence penalty should not be warranted if the taxpayer provides evidence that the taxpayer contacted the CDTFA to inquire about the proper application/reporting of tax and was misinformed by CDTFA staff. However, the taxpayer remains liable for the applicable tax or fee and interest.
The taxpayer is required to furnish reasonable proof that the underreported tax was the result of erroneous information from the CDTFA. Proof that the underreported tax or fee was the result of the taxpayer's reasonable reliance on erroneous information from CDTFA. In addition, the taxpayer should furnish a written statement of their interpretation of the information provided by CDTFA team members. In addition, the taxpayer should furnish a written statement of his or her interpretation of the information provided by the CDTFA staff.

FAILURE TO REPORT PURCHASES SUBJECT TO USE TAX 0508.35

The same standards which determined the application of the negligence penalty to tax deficiencies arising from an understatement of gross receipts or an overstatement of claimed deductions are used to determine the application of the negligence penalty to a tax deficiency arising from failure to report purchases subject to use tax.

MORE THAN ONE LOCATION 0508.40

A taxpayer operating under a consolidated permit multiple locations, who fails to include on returns, sales relating to a location for which a subpermit is held, may be presumed to be negligent for all tax due for that location that sublocation unless such omissions are infrequent and do not constitute a substantial part of the total deficiency.

OTHER TYPES OF NEGLIGENCE 0508.45

While the situations described in AM sections 0508.35 and 0508.40 are rather obvious cases of negligence in preparing returns, it is not intended that the imposition of the negligence penalty for this reason be so limited, since many other types of situations will be encountered where items have been omitted from returns for no apparent reason except that the taxpayer was negligent.

WORKING PAPERS ARE DESTROYED 0508.50

When the auditor finds that working papers used by the taxpayer in preparation of the tax or fee returns or reports have been destroyed and the taxpayer is unable to explain substantial deficiencies in reporting, the taxpayer should be given a reasonable opportunity to prepare new working papers or to explain how amounts reported on returns were computed. Failure or inability on the part of the taxpayer to do so will ordinarily constitute evidence of negligence and warrant the imposition of the 10-percent negligence penalty.
Page separation for updated section 0512.00
MISCELLANEOUS

FAILURE TO OBTAIN EVIDENCE THAT AN OPERATOR OF A CATERING TRUCK HOLDS A VALID SELLER'S PERMIT

Pursuant to RTC section 6074, CDTFA may require any person making sales to an operator of a catering truck to obtain evidence that the operator is the holder of a valid seller’s permit, issued pursuant to RTC section 6067. Persons who fail to comply with that requirement to obtain evidence shall be liable for a penalty, not to exceed five hundred dollars ($500), for each such failure to comply.

Any person making sales to an operator of a catering truck who has been required by the CDTFA pursuant to RTC section 6074 to obtain evidence that the operator is the holder of a valid seller’s permit issued pursuant to RTC section 6067 and who fails to comply with that requirement shall be liable for a penalty not to exceed five hundred dollars ($500) for each such failure to comply.

FAILURE OF A RETAIL FLORIST TO OBTAIN A PERMIT

Pursuant to RTC section 6077, any retail florist (including a mobile retail florist) who fails to obtain a seller’s permit before engaging in or conducting business as a seller shall, in addition to any other applicable penalty, pay a penalty of five hundred dollars ($500). For purposes of RTC section 6077, this regulation, “mobile retail florist” means any retail florist who does not sell from a structure or retail shop, including, but not limited to, a florist who sells from a vehicle, pushcart, wagon, or other portable method, or who sells at a swap meet, flea market, or similar transient location. The term “retail florist” does not include any flower or ornamental plant grower who sells his or her own products.

PENALTIES IN BANKRUPTCY CASES

In bankruptcy cases, tax penalties for pre-bankruptcy periods should be determined in the same manner as for persons not in bankruptcy. Penalties are not entitled to the same priority treatment as pre-bankruptcy taxes and accrued interest. However, penalties may be entitled to a distribution under a lesser priority. The Special Procedures Section of the Collection Support Bureau will make an evaluation whether to include penalties in a proof of claim to be filed in a bankruptcy case. When a tax penalty is not discharged in a bankruptcy case, the penalties associated with the tax liability are likewise not discharged and any penalty should be included in the determination so it can be collected from the tax debtor.

The date the bankruptcy petition is filed must be noted in the audit. Pre-petition and post-petition penalties should be separately identified in each (pre and post) audit.

RECEIVERS, TRUSTEES AND DEBTORS IN POSSESSION

Trustees of bankruptcy estates and debtors in possession. A court-appointed receiver, bankruptcy trustee, or taxpayer/bankruptcy debtor (acting as a debtor-in-possession) may operate the business of a taxpayer following the commencement of litigation against a taxpayer or the commencement of a bankruptcy case. They may operate the business of a debtor. Accordingly, penalties that attach due to the delinquency or malefeasance of a receiver, trustee, or debtor-in-possession while operating the business will be billed to the receiver, trustee, or debtor-in-possession and, when appropriate, asserted as a claim against the receivership or bankruptcy estate. Which attach by reason of the delinquency or malefeasance of a trustee, or debtor-in-possession while operating a business will be billed to the trustee, debtor-in-possession, and bankruptcy estate.
NEGLIGENCE AND EVASION PENALTIES — DECEASED TAXPAYERS  0510.30 0512.30

Negligence and evasion penalties will not be included in determinations made after the death of an individual taxpayer. It is obvious that the malfeasant in such cases would not suffer the penalty, and the effect would be to reduce the assets for distribution to the estate of the deceased. However, such penalties are applicable to the negligence of the administrator(s) or executor(s) of the decedent’s estate, or their intent to evade the payment of tax or fee.

NEGLIGENCE AND EVASION PENALTIES — DEATH OF PARTNER  0510.35 0512.35

If a partnership is properly subject to a negligence or evasion penalty, that penalty will still be imposed even if the partnership is thereafter dissolved due to the death of one of the partners.

ASSIGNMENT FOR THE BENEFIT OF CREDITORS  0510.40 0512.40

Any person who makes an assignment for the benefit of creditors and who owes an amount which became delinquent either before or after the assignment was made, is charged with penalty and interest, when applicable, the same as other taxpayers.